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EQB.TO - Q1 2014 Equitable Group Inc Earnings Conference Call

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Graham Ryding *TD Securities - Analyst*

Geoff Kwan *RBC Capital Markets - Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Equitable Group First Quarter 2014 Conference Call. We would like to remind you that certain forward-looking statements may be made on this call including statements regarding possible future business and growth prospects. You are cautioned that such forward-looking statements involve risks and uncertainties detailed in the Company's periodic filings with Canadian regulatory authorities. Many factors could cause actual results or performance to be different from those expressed by such forward-looking statements. Equitable does not undertake to update any forward-looking statements made by itself or on its behalf except in accordance with applicable security laws.

This call is being recorded for replay purposes. It's now my pleasure to turn the call over to Andrew Moor, President and CEO of Equitable Group and Equitable Bank. Please go ahead, Mr. Moor.

Andrew Moor - *Equitable Group Inc - President, CEO*

Thank you, Genevieve. Good morning everyone. Joining me is Tim Wilson, Chief Financial Officer of the Bank and Equitable Group. Before getting started I would like to advise that we added a slide deck to the webcast of our call.

Equitable opened 2014 by setting a new performance record in the first quarter. Operationally the Bank also executed very well on our growth and diversification strategies.

On the lending side we delivered record first quarter single-family originations, up 42% over the same period last year and pushed through the CAD4 billion threshold in mortgage principle for the first time in that business line. During a particularly cold start to the year that likely blunted some housing market activity, this was a real accomplishment that speaks to the ongoing efforts of our team in using service to attract new customers and to build long-term customer loyalty.

We also opened our Single Family operations, a business in Quebec on March 31, which means we now have a dedicated presence in 7 provinces and all of Canada's largest cities. We continue to prepare to launch Equitable as a prime mortgage lender, an important strategic initiative that should help to augment our presence in the single-family market and create substantial value for the Bank in future years.

On the deposit side of our business we continue to experience a steady increase in demand for our new Equitable Bank high-interest savings account, a complement to our GICs. It has attracted over CAD120 million of funds as of this morning.

Broadening our services to Canadian Savers and are sources of cost-effective funding is a long-term priority and was also aided just after the quarter for a successful CAD150 million deposit note offering. We'll discuss each of these highlights in today's call.

First I'd like to summarize what our growth and development meant for shareholders in the first quarter. Compared to last quarter, diluted EPS increased 20% -- compared to last year rather, diluted EPS increased 20% to a first-quarter record of CAD1.56. This is an excellent outcome, but it should be noted that our earnings would have been even higher if not for additional non-interest expense related to the appreciation of Equitable's common stock price and to severance costs that we wouldn't expect to recur in normal quarters.

ROE was 17.9%, up from 17.5% and well aligned with our consistently high average over the past five years. Book value per share increased 18% year-over-year and 4% during the quarter itself. These strong results and our positive outlook gave our Board cause to once again raise our common share dividend at their meeting yesterday. We are very pleased to note that we will now pay, beginning in July, at a rate of $0.17 per quarter, up 13% from a year ago. This is our sixth increase in just over three years.

Underlying our record first quarter results was solid growth in the Bank's core lending businesses, both single family and commercial lending services where mortgage principle was up 20% year-over-year.

Leading the way in growth once again this quarter and by design was our Single Family Lending Services business. On strong origination volumes and mortgage renewal success, single-family mortgage principle at March 31, was up 28% to CAD875 million to CAD4 billion. Normalized for the securitization of CAD238 million of single-family mortgages over the past year, the growth rate of the portfolio was an even more impressive 35%.

As a reminder, when mortgages in our core lending operations are securitized, we being to report the balances in our securitization financing results and the impact is a decrease in core lending assets.

CAD4 billion of principle means that we have increased the size of this business by more than 466% since we made it a focal point of our expansion efforts in June 2009.

Origination levels in the first quarter totaled CAD404 million, up 42% from a year ago to a new first quarter record. We expected a strong first quarter and we're definitely not disappointed. This performance results from Equitable's continued efforts to deliver responsive service to the mortgage broker and provide housing financed to entrepreneurs and people newly establishing themselves in Canada.

Although there continues to be a lot of debate about a soft landing in the market, we are now several weeks into the second quarter and we continue to see good demand in the single-family business.

The Bank's Commercial Lending Services mortgage principle expanded 10% to CAD2.4 billion. While originations of CAD126 million were below last year's first quarter due primarily to lower commercial market activity, renewal activity was strong and as a result balances were down only marginally from Q4. Our growth has also continued to benefit from expanded partnerships in the commercial mortgage market.

In securitization financing, mortgages under management remained at the same level at CAD5.8 billion in line with our expectations. As in prior quarters, the need to use our CMB capacity to fund elevated levels of maturing mortgages did not leave much room to grow this business. Recently our CMB capacity has been running at approximately the same level as our volume of maturities, and this situation is expected to prevail until the end of 2014.

Generally we have experienced strong demand for our multi-unit residential mortgage product and continue to see profitable opportunities for this business going forward.

The Bank's growth in returns have continued to be positively influenced by disciplined underwriting standards and credit practices by a generally positive economic backdrop.

You may remember that we began reporting a metric that we refer to as our impairment provision last quarter. The metric represents our provision for credit losses on impaired mortgages and in our opinion is the best indicator of loss rates on our portfolio. In the first quarter we had a net impairment recovery of CAD36,000. The recovery results from the restructuring of one large commercial loan and low loss expectations for newly impaired loans.

I also want to point out that we added only CAD500,000 to our collective allowance in the quarter, a much lower amount than has been our recent practice. Our overall allowance continues to bump at the top, high end of our target range.

I'll now ask Tim to provide his analysis of the quarter before discussing our outlook.

Tim Wilson - *Equitable Group Inc - VP, CFO*

Thanks, Andrew. Total net interest income was up 21% year-over-year on 8% growth in assets under management and a very healthy 25 basis point increase in NIM which stood at 1.67%. NIM also grew sequentially and is now sitting at its highest level in over three years. This reflects the continued shift in our asset mix towards our higher margin core lending businesses and wider spreads within core lending itself. In fact, core lending NIM increased 28 basis points year-over-year due primarily to improvements in our single-family renewal pricing and more efficient management of our liquidity portfolio.

Securitization financing NIM was down 4 basis points because of lower mortgage pre-payment income and the fact that recent originations and renewals have been at lower spreads than our maturities. The maturing mortgages were originated mainly during 2009 when spreads were significantly higher than they are today.

Looking ahead, our expectation for NIM performance in 2014 is unchanged from last we spoke. That's to say that we believe total NIM will increase during 2014 on the continuing shift in our asset mix, although it may experience some fluctuations quarter-to-quarter due to inherently volatile mortgage pre-payment charge income.

With respect to other income, you'll notice that our gains from securitization were consistent with Q1 of last year but down 52% from the prior quarter. We did use the majority of our CMB capacity in Q1, and the lower gains on sales are driven by the types of mortgages originated and securitized. Non-pre-payable mortgages, the type that allow us to achieve derecognition, represented 25% of assets securitized in Q1 in contrast to 53% in Q4. This change in mix was simply a function of current market demand.

I'll also remind you that the gains will now slow through the income statement over time and our net economic position is really unchanged.

We're cautious about providing guidance on our securitization mix going forward, but based on current market activity, believe that our gains could fall anywhere in between the Q4 2013 and Q1 2014 levels in the future, a reduced expectation from past quarters.

Shifting to costs, our non-interest expense growth was elevated by the 22% appreciation in our stock price during the first quarter and some severance which together represented CAD600,000 of increased compensation costs compared to both Q1 and Q4 of last year. Expenses also increased in the quarter due to FTE growth and the associated office and equipment costs. Finally, we began to amortize our HELOC investments in Q1 which contributed CAD300,000 of costs, ahead of any revenue I would add since this product is just gaining some scale now.

Accordingly, Equitable Bank's efficiency ratio was 31.9%, up 1.6 points from last year and 3.5 points higher than in Q4. You'll note that we are now using the term efficiency ratio rather than productivity ratio in order to better align with industry practice.

Looking forward, as a result of planned growth in the business and our strategic diversification initiatives, we expect the Bank's efficiency ratio in 2014 to remain slightly higher than in 2013. Even so, Equitable will remain one of Canada's most cost effective banks, reflecting the advantages of our branch with business model.

Turning to our outlook for credit quality, given the quality of mortgages we've added in recent periods and assuming Canadian employment levels and interest rates trend as anticipated, we expect our single family arrears rates and losses will remain low in 2014, although they will likely trend upwards from Q1 to levels more in line with historic norms. Arrears and losses in our commercial portfolio should also remain low.

In terms of capital, all of Equitable Bank's ratios continue to surpass minimum regulatory standards and most competitive benchmarks. Our period-end capital ratios were all up slightly from the fourth quarter and from a year ago mainly due to the organic growth of our equity. We also helped our capital ratios by portfolio ensuring CAD179 million of single-family mortgages during Q1. As a result, Equitable remains well positioned to support continued growth and value creation.

As Andrew mentioned, subsequent to Q1 we successfully completed CAD150 million deposit note offering which adds depth and breadth to our cost effective funding sources. We issued a 3-year, fixed-rate deposit note at a 135 basis point spread to govern in Canada yields and it has since traded in to a spread of 123 basis points. I'm pleased to say that the offering was over-subscribed and attracted broad institutional investor demand. Since the Bank intends to become a regular deposit note issuer across a variety of terms, we are really pleased with market reactions to this inaugural offering.

Now, back to Andrew for his outlook.

Andrew Moor - *Equitable Group Inc - President, CEO*

Thanks, Tim. Looking ahead to the rest of 2014, our outlook is unchanged since our last call in February and is pretty well spelled out in our [MB&A]. We expect that our strategy including our approach to capital allocation will continue to deliver high returns on shareholder's equity throughout the year.

From a mortgage origination standpoint as we move into the spring and summer quarters, we look to take advantage of seasonally stronger real estate and mortgage market activity by maintaining the standards of service and responsiveness that made Equitable the favored choice of mortgage brokers and borrowers across Canada.

The risk of slowing residential real estate activity has obviously not gone away, but capitalizing on the recent progress we have made in diversifying the Bank's products and market reach should have a broad and positive impact on our prospects.

With respect to diversification, I mentioned at the outset that we opened in Quebec single-family market right at quarter end. The focus for our team is on Montreal and Gatineau. While we've only been operating for a few weeks now, the deal flow is beginning and we're building relationships with the local and national mortgage brokers operating in these vibrant markets.

I'm also pleased to say that we have done the due diligence and are now ready to enter the prime single-family lending market. We recently hired [Martin Bobray], an experience prime lender to build this operation with Brian Leland, our VP of Residential Lending and Kim Kukulowicz, VP or Residential Sales, and others on the Equitable team.

This is an exciting opportunity for the Bank that will, over time, expand our reach within the mortgage broker channel and deepen our customer relationships. We intend to fund the majority of our prime mortgages through the MBS securitization program, which we have defined volumes allocated each quarter by CMHS.

With access to low-cost funding and our current strategy, we believe we will be able to originate between CAD1 billion and CAD2 billion of loans annually within a 3- to 5-year time horizon.

In 2014 as we ramp up our prime business, we're not expecting material impact on earnings per share. Once we do reach critical mass we'll have a foundation for significant long-term strategic and financial value creation. However, as you know, margins of prime lending will be governed by spreads between the MBS market and prevailing mortgage rates, so we expect earnings to be a bit more volatile for our prime business than our other businesses.

2014 will also be a growth year for our highest interest savings account and our home equity line of credit, and we're encouraged by our progress on both of these fronts so far. These products diversify our offering and extend our ability to deliver valuable financial service solutions to a broad range of customers.

In summary, the Bank opened in 2014 with record first quarter results and characteristically strong ROE. We set a new high (inaudible) market mark for single-family mortgage principle, and first quarter single-family origination volumes were up 42%. And we continue to grow the trusted deposit-taking bank.

Overall our outlook for 2014 is positive. We have many opportunities to grow and a plan in place to ensure our ambitions are realized in a risk-managed and cost-effective manner. That concludes our prepared remarks and now we'd like to invite your questions. Operator, can you please open the lines to our callers?

QUESTIONS AND ANSWERS

Operator

Ladies and gentlemen, we will now conduct the question-and-answer session. (Operator Instructions.) Your first question comes from Graham Ryding with TD Securities. Please go ahead.

Graham Ryding - *TD Securities - Analyst*

Thank you. Maybe I could start with your Quebec initiative. Just can you flush out how many people you've had to hire to get this sort of initiative off the ground? And what is your sort of initial plan to get business flowing?

Andrew Moor - *Equitable Group Inc - President, CEO*

We've hired about five people in the province, so that includes (inaudible), underwriters, a team lead, and a sales person. So modest so far until we see the volumes growing. We're not expecting to do material volume this year. If we can do somewhere in the sort of CAD30 million-ish range that would be good. Learn the market as we always do. Make sure we don't make any credit mistakes in the early going. And then build from there in ongoing years.

Graham Ryding - *TD Securities - Analyst*

So could you give me an idea, like you gave some decent color around your single-family initiative within three to five years. What about Quebec? Where do you see this potentially growing to within three to five years?

Andrew Moor - *Equitable Group Inc - President, CEO*

Within three to five years probably at a couple hundred million to origination volumes in the alternative space.

Graham Ryding - *TD Securities - Analyst*

So, sorry, annually CAD200 million or --?

Andrew Moor - *Equitable Group Inc - President, CEO*

Annually. Yes. Annually.

Graham Ryding - *TD Securities - Analyst*

Okay. Thanks.

Andrew Moor - *Equitable Group Inc - President, CEO*

It's a bit hard for us to know, Graham. We don't have really good sort of [prudential] data and so on, so that's -- we'll update you as we get a better sense for the market.

Graham Ryding - *TD Securities - Analyst*

Yes. Okay. But that gives me some context. With your -- the securitized assets that are coming up for renewal this year, is the CMB the only channel that you can securitize these renewals in? I guess you can't use the NHA MBS for this stuff? Is that correct?

Andrew Moor - *Equitable Group Inc - President, CEO*

We could the NHA MBS, but the way the pricing works in the multi-family mortgage market, effectively there's no spread between MBS and the pricing on the mortgages, so there's no profit in it to do that. So effectively you have to use CMB capacity if you want to be making money in that business, so that becomes the practical constraint.

Graham Ryding - *TD Securities - Analyst*

Got it. And then your ACM multiple ticked up and I guess you provided guidance that you expect it to tick up further. Do you have the ability to manage around this with potentially selling some mortgages through the interest-only strips to bring this down or how are you looking at sort of managing this multiple going forward?

Andrew Moor - *Equitable Group Inc - President, CEO*

First of all we believe we've got lots of room on our current ACM so we don't feel at all constrained or concerned about that at this point. I'll let Tim address the issue about where we stand with the sale of strips, although that's certainly something that we believe will become open to us.

The other complexity that we need to worry about around ACM is that starting in January of next year we'll actually be moving to the Basel III leverage ratios, so the ACM that we currently report won't be the relevant metric. Now we're not expecting that that's going to change the [amount of] leverage and that's sort of what [LCE] is indicating to all institutions is expect your leverage ratio to be -- continue to be -- to allow the same kind of asset growth as you have today and it'll be measured off a different basis, so it'll be measured off the CET1 rather than total capital. So there is a little bit of complexity around leverage that we have to keep an eye on over the next 12 months or so.

And Tim, I don't know if you'd make some comments about the sale of strips?

Tim Wilson - *Equitable Group Inc - VP, CFO*

Yeah. And on the IO strip question, Graham, we continue to be active in the market, meeting with investors, talking about potential structures, and also discussing those structures with CMHC. As you're aware, we need their approval for any structures to proceed with them and get derecognition.

And I think Andrew mentioned, we're not constrained by our ACM right now so we're not rushing this process. We're trying to figure out the best structure for the long term and not rush into something that'll compromise our business.

Andrew Moor - *Equitable Group Inc - President, CEO*

I'm sorry, Graham. I realize I misspoke. It is not CET1, it's tier 1 that the leverage ratio is going to be based off.

Graham Ryding - *TD Securities - Analyst*

And when do you expect to get some guidance on that tier 1 leverage ratio?

Andrew Moor - *Equitable Group Inc - President, CEO*

I think it's going to be late summer/early fall is my sense. And there's a lot of work going on [obviously] in that regard at this point.

Graham Ryding - *TD Securities - Analyst*

Okay. I'll jump back in if I have more. Thanks.

Operator

Your next question comes from Geoff Kwan with RBC Capital Markets. Please go ahead.

Geoff Kwan - *RBC Capital Markets - Analyst*

Hi. Good morning. First question I had was how is activity so far in Q2? I mean Q1 was clearly a weaker quarter for it seems like the industry with the winter weather, but when you adjust for that and just say okay, well if the weather wasn't necessarily that bad, how is Q2 kind of shaping up? Like how would you generally characterize it so far?

Andrew Moor - *Equitable Group Inc - President, CEO*

I'd characterize it as a bit regional, so I would say the West is stronger than the East. And it's strong. We're busy, but it does feel like a bit of a delayed spring market perhaps. So busy but not run off our feet I would describe it as we speak today or as it's been for the last couple of weeks. And this is the time of the year that we would hope to get run off our feet. I'm hoping that will still emerge over the next three to four weeks which when it starts to be the peak of the seasonality, but it does seem a little bit delayed.

Geoff Kwan - *RBC Capital Markets - Analyst*

Okay. And the second question I had was have you done any sort of initial kind of work with the broker community around the launch on the prime side and kind of how's the feedback been so far?

Andrew Moor - *Equitable Group Inc - President, CEO*

Yeah. We've gone out to a limited number of brokers to talk to them about the offering that we've -- a number of options that we've been contemplating and it seems to be well received. I would say that we still haven't landed on some of the decisions we have to make yet and it'll still take a month or two to do that. We don't expect to be in market to be clear with the prime offering until the end of July, so we've still got a few decisions to make there, but I think we feel that we've got an offering that's going to provide value to that broker community.

Geoff Kwan - *RBC Capital Markets - Analyst*

And it's going to be a little bit of a targeted approach in terms of the key broker partners that you're working with and then eventually expand? Or would you keep it open to any broker that wants to submit an application?

Andrew Moor - *Equitable Group Inc - President, CEO*

I think we would -- our approach generally is to treat everybody equally and offer excellent service to every broker that chooses to want to come and try and do business with us. But we would obviously go out and seek and have more detailed conversations with those brokers we have close relationships with. So I would expect the volume to be coming from a fairly small number of brokers, but we certainly never close the door on anybody that chooses to do business with us.

Geoff Kwan - *RBC Capital Markets - Analyst*

Okay. Great. Thank you.

Operator

(Operator Instructions.) And Mr. Moor, there are no further questions at this time. Please continue.

Andrew Moor - *Equitable Group Inc - President, CEO*

Great. As there are no other questions, I'd like to thank you all for joining us and remind you that our annual general meeting is -- our annual meeting of shareholders is next week on May 14, at 4:15 Eastern at the TMX Broadcast Centre. We hope to see you there and it's an opportunity to meet some of our new members of the Board.

We look forward to report -- if we won't see you there, we look forward to reporting our second quarter results on August 13, with a call on August 14. Thanks for your interest and goodbye for now.

Operator

Ladies and gentlemen, this concludes the conference call for today. Thank you for participating. Please disconnect your lines.